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Rt. Hon. Margaret Thatcher, M.P.
10 Downing Street
London, England

Dear Prime Minister:

I am writing, at the suggestion of your secretary, to summarize two critical issues about control of the money stock and to make my views on these issues available for your further consideration.

The two issues involve two risks that must be compared. One is the policy risk -- the risk that the technique of monetary control produces errors that jeopardize your medium-term strategy. The second risk is the operational risk -- the risk that some banks and financial institutions misunderstand, or adjust slowly, if new procedures for controlling money are adopted.

The first issue has overriding importance. I believe that the current procedures of the Bank of England will continue to cause substantial variability in the growth of money from announced targets. The typical pattern of deviations allows the rate of monetary expansion to be greater in months of recovery and economic expansion than in months of recession.

One result of systematic deviations of this kind has been the rising average rate of inflation in the U.K. and the U.S. from cycle to cycle. A second result is that the severity of recessions is often increased, because money growth collapses during recessions. Many measures of money growth, but not £M3, suggest that the current recession is not an exception.

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The current system of monetary control requires the Bank of England to know where to set the minimum lending rate and how quickly to adjust the rate when economic conditions change. No one has this information. Furthermore, the present system almost assures that the Bank will finance large, unanticipated increases in the public sector borrowing requirement.

The recent pattern of errors by the Bank, if repeated in the forthcoming recovery, is likely to produce rising inflation in 1983 or 1984. There is, therefore, a serious risk that your government would be called upon to take measures to slow the economy at an inopportune time. To this political cost, one must add the risk that the very high cost now being paid in Britain to reduce inflation will not produce the permanently lower rate of inflation for which you have strived.

Judging from the questions that seemed to preoccupy the officials of the Bank at our meeting on Tuesday, I believe the officials will place great emphasis on the second issue -- the adjustment of the banks and the financial system to new and different procedures.

I do not claim that there is no risk of error or misjudgment during the transition to a new method of control, and I do not believe the banks can adjust instantly to a new system. The Bank is inclined to overstate the risk and to overestimate the time required for adjustment. Most of the U.K. banks, and all of the largest banks, operate in economies with rules that differ in a variety of ways from current U.K. practice. A few examples suffice. In most systems there are no overdrafts; banks hold required reserves, and must meet reserve settlement dates; banks buy and sell surplus reserves to one another instead of relying exclusively on the central bank. One should believe that many of the banks have, among their officers, people with experience, knowledge, skill and an understanding of a broad range of techniques and procedures.

The rate of inflation shows signs of falling. A start has been made toward a lower rate of private sector wage increases. Costs of production are falling, albeit slowly, in response to competition, slower inflation and the greatly reduced costs of imported raw materials. These are the results of your policies. There is evidence that the saving rate has risen, sustainedly, in response to your tax program. If inflation is permanently reduced, private sector money wage increases will continue to fall, while rising real wages stimulate spending and bring the recession to an end.

The unfinished task is to convert these temporary achievements into permanent gains. Sustained reductions in private sector wage increases will help to bring public sector wage increases under control. Better control of money growth, and a better monetary target than £M3, is important to reduce uncertainty about the ability of your government to achieve its laudable objectives.

If I can be of any further assistance, Prime Minister, please be assured that I will be happy to help either on my visit next spring or at your request.

Very truly yours,

Allan H. Meltzer

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AHM/jep